A benchmark "based on typical system costs"[99/] would share the flaws of a cost-of-service approach and would, in addition, ignore the critical differences among cable systems. It, too, would focus exclusively on operators' costs of providing leased access channels -- but it would attempt to determine average or "ideal" system costs, setting a single benchmark for all systems.

In order to take into account the effects of a leased access channel on a system's operations, it is necessary to take into account the manner in which cable systems assemble their own packages of programming. In assembling such packages, operators virtually never negotiate identical terms and prices for all program services. Operators pay different amounts for different services, and these differences are based on the different operating costs of such services, the different demand for such services among consumers, and the different value that each service brings to the tier or package of services provided by the operator. In reselling such services to subscribers, the operator must establish prices that cover its costs plus a reasonable profit. And the prices at which individual services are purchased are not uniform, nor are the prices at which they are resold.

While cable operators typically pay programmers for their services and then resell those services to consumers, those relationships could be conceptualized as "lease" arrangements.

99/ Id., para. 148.

Suppose, for example, that a cable operator pays a premium movie service five dollars per subscriber for its service and resells the service to subscribers for nine dollars. This is, in effect, the same as if the movie service "leased" the channel for four dollars and resold it itself for nine dollars. The implicit leased access charge in such an arrangement is four dollars.

The implicit leased access charge for other services will be different. Premium services that can be resold for several dollars more than their cost will obviously have a higher implicit leased access charge than basic services that produce less revenue per-channel. By effectively charging different access "rates" to different programmers -- so long as the overall revenues from all services cover costs plus a reasonable profit -- operators are able to provide a more diverse array of high-cost and low-cost programming than if they were required to lease channels at uniform, non-discriminatory rates.

To preserve this mix of programming, the cable operator should in no circumstances be required to provide additional channels, on a leased access basis, at a rate that is lower than the highest implicit leased access charge "paid" by any programmer on its system. Suppose, in the previous example, that the operator were required to lease channels at three dollars per subscriber per channel. A competing movie service could lease a channel at that rate and divert subscribers and revenues from the movie service provided by the cable system, whose implicit leased access charge was four dollars per subscriber. In order to continue to cover its costs, the operator would have to raise the

implicit access charges paid by other services that it carried -- in other words, pay less per subscriber for such services or raise the rates charged to subscribers for such services. This could make it economically impossible to continue to carry certain lower-priced services on the system.

This is precisely the sort of effect that Congress sought to avoid by providing that leased access rates were not to "adversely affect the operation, financial condition, or market development of the system." If a maximum rate -- or maximum rates for different classes of services -- are to avoid such adverse affects, such rate or rates must be no lower than a system's maximum implicit access charge for each particular class of service.

Such a maximum rate, to be applied on a case-by-case basis under the streamlined procedures mandated by the Act, will prevent the unreasonable charges that Congress feared while preserving the diversity of programming on cable systems that Congress meant to protect and enhance.

CONCLUSION

The Commission's standards and procedures implementing the Act's rate regulation provisions must be carefully crafted to achieve what Congress intended. A benchmark approach is preferable to cost-of-service regulation, both to ensure "reasonable" rates for basic service and to rein in the "unreasonable" non-basic rates of a minority of cable systems.

But the different benchmark approaches for basic and non-basic rates must take into account the different policy concerns and objectives of Congress. And, in any case, they must provide adequate safety valves to ensure that, in each particular case, cable systems are not prevented from recovering their costs plus a reasonable profit.

For the foregoing reasons -- and, in particular, to ensure that rate regulation does not stifle the growth of cable television and its ability to meet the needs and desires of its customers -- the Commission should adopt the benchmark approaches, rules and procedures described in these comments.

Respectfully submitted,

NATIONAL CABLE TELEVISION ASSOCIATION, INC.

By _____
Daniel L. Brenner

By _____
Michael S. Schooler

By _____
Diane B. Burstein

ITS ATTORNEYS

January 27, 1993

1724 Massachusetts Avenue, N.W.
Washington, D.C. 20036
(202)775-3664

CABLE RATE REGULATION
A MULTI-STAGE BENCHMARK APPROACH

Bruce M. Owen
Michael G. Baumann
Harold W. Furchtgott-Roth

January 27, 1993

ECONOMISTS INCORPORATED

CONTENTS

CABLE RATE REGULATION

A Multi-Stage Benchmark Approach

The Federal Communications Commission is faced with implementing a practical interpretation of the intent of Congress based on the Cable Television Consumer Protection and Competition Act of 1992 ("Cable Act of 1992"). In its Notice of Proposed Rulemaking,[1] the Commission described two general regulatory approaches: cost-of-service regulation and benchmark rates. This paper presents a proposal to regulate cable rates through the use of a three-stage approach.[2] The first stage would establish benchmark rates, below which rates are reasonable. The second stage—providing for cases where cable systems face unusual or extreme service requirements—would serve as a second screening device to reduce the administrative burdens on subscribers, cable operators, franchising authorities, and the Commission.[3] The third stage would allow for

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1 Implementation of Sections of the Cable Television Consumer Protection and Competition Act of 1992, Rate Regulation, MM Docket No. 92-266, *Notice of Proposed Rulemaking*, (hereafter, Notice) (released Dec. 24, 1992).

2 For a general policy discussion of rate regulation of cable television service, see Owen & Wildman, *Video Economics* (1992) 250-54.

3 "In prescribing such regulations, the Commission—"(A) shall seek to reduce the administrative burdens on subscribers, cable operators, franchising authorities, and the Commission; (B) may adopt formulas or other mechanisms and procedures in complying with the requirements of subparagraph (A);" Communications Act, § 623 (b) (2) (A), (B), 47 U.S.C. § 543 (b) (2) (A), (B).

a full cost-of-service regulatory proceeding. As the paper discusses, these three stages are integrally linked and cannot be separated from one another.

This paper discusses a methodology for establishing benchmark rates for basic service based on rates charged by systems facing effective competition as defined in the Cable Act of 1992.[4] The paper also presents a similar, but distinct, methodology for establishing benchmark rates for cable programming services (that is, tiers of service beyond the basic tier as well as associated equipment) based on the overall experience of the cable industry.[5] Further, this paper proposes methods to adjust the benchmark rates over time and to allow systems below the benchmark to modify their rates.[6] Consistent with the Act, rates for services offered on a per-channel or per-program basis would not be regulated.

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4 Components of "basic service" are defined at Communications Act, §623 (b) (7), 47 U.S.C. § 543 (b) (7). The term "effective competition" is defined at Communications Act, § 623 (l) (1), 47 U.S.C. § 543 (l) (1).

5 The term "cable programming service" is defined at Communications Act, § 623 (l) (2), 47 U.S.C. § 543 (l) (2).

6 While there are strong public policy and practical reasons to adopt a benchmark approach that regulates equipment used to receive basic service in a common basket with the basic service tier, it is assumed for purposes of this paper that rates for such equipment will be regulated outside of the basic service tier. To be precise, the assumption is that installation and certain items of equipment used only in connection with basic service will be rate regulated on the basis of cost plus a reasonable profit either individually or as part of an equipment basket. Further, as discussed below, the subscriber revenues from regulated items of equipment should be taken into account in setting benchmark standards for cable programming services.

It is easy to agree with the Commission's tentative conclusion that cost-of-service regulation should not be the primary mode of regulation of cable service rates, but rather should only be used as a last resort to establish the reasonableness of a rate above the applicable benchmark rate. It is well established that cost-of-service regulation is a costly and inefficient mode of regulation that imposes undue burdens both on regulated firms and consumers.

Achieving "cost-based" regulation through competitive standards

Although "cost" is among the many criteria identified in the statute for the regulation of various cable television rates, equipment fees, and installation fees, traditional cost-of-service, rate-of-return regulation is well-known to diminish incentives to produce and to invest efficiently, harming consumers.[7] The Notice implies that a cost-of-service approach is unsuited for the primary method of regulating basic service and cable programming services. Some more incentive-compatible method of regulation seems called for.[8] One possibility is to interpret those passages of the statute that call for "cost-based" regulation in light

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7 "Our experiences administering rate of return regulation lead us to conclude that this methodology has certain inherent flaws. ...[T]his type of regulation presents carriers with certain incentives...that are perverse when viewed from a public interest perspective." "Under rate of return...'normal' profit levels are established in advance by fiat. The dynamic process that produces socially beneficial results in a competitive environment is strongly suppressed. In fact, rather than encourage socially beneficial behavior by the firm, rate of return actually discourages it." FCC, *Policy and Rules Concerning Rates for Dominant Carriers (Price Caps), First Report and Order* (1989).

8 "The attractiveness of incentive regulation lies in its ability to replicate more accurately than rate of return the dynamic, consumer-oriented process that characterizes a competitive market." *Id.*

of the overall Congressional intent to achieve rates for *basic* service that are as close as possible to those that would result from competition. Generally speaking, competition drives prices toward costs (see Notice at ¶ 152, citing Stigler, *The Theory of Price*, 4th ed. at 178-192 (1987)). In order to achieve "cost-based" regulation, the Commission can establish rates on the basis of benchmarks derived from competitive cable television systems. In this way, regulated rates can be "based on costs" (the costs of benchmark competitive systems). At the same time, incentives to produce and to invest efficiently can be maintained by using a regulatory method that does not depend explicitly on the costs of the system being regulated.

Overview of the regulatory framework

The statute identifies three categories of cable television subscriber rates and calls for very different regulatory treatment of the three. The first category, to be regulated most strictly and on the basis of effective competition, among other factors, consists of rates for the basic service tier.[9] At the first stage the basic service tier can be regulated under an "effective competition" standard with benchmark rates established on the basis of comparison to rates charged by cable systems subject to effective competition.

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9 The regulation of installation and equipment used to receive the basic service tier also falls in the section of the Cable Act of 1992 that addresses basic service tier rate regulation, but this paper does not consider separate cost-based regulatory standards for equipment leasing, additional outlets, or installation. Establishment of basic service tier rate regulations are discussed at Communications Act §623 (b), 47 U.S.C. §543 (b). The regulations for equipment, additional outlets, and installation are discussed at subsection (b).

The second category, cable programming services, consists of one or more tiers of service beyond the basic service tier. The Act provides for different regulation of basic service than for cable programming services.[10] While regulation of basic service would be ongoing by local authorities, based on comparisons with effectively competitive systems, regulation of cable programming services would be triggered only by complaints to the Commission and would rely on a different standard. Regulation of cable programming services falls under the section of the Cable Act of 1992 that addresses regulation of "unreasonable" rates. At the first stage this category should be regulated under a standard that singles out those cable systems with exceptionally high rates relative to other comparable regulated systems offering similar levels of programming service.

The third category consists of unregulated subscriber services, such as premium and pay-per-view channels and cable guides.

REGULATING BASIC SERVICE RATES

The Commission is directed to protect "subscribers of any cable system that is not subject to effective competition from rates for the basic service tier that exceed the rates that would be charged for the basic service tier if such cable system were subject to effective competition."[11]

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10 Establishment of basic service rate regulations are discussed at Communications Act, § 623 (b), 47 U.S.C § 543 (b). Regulation of unreasonable rates for cable programming services is discussed at Communications Act, § 623 (c), 47 U.S.C. § 543 (c).

11 Communications Act, § 623 (b) (1), 47 U.S.C. § 543 (b) (1).

In carrying out this mandate, the Commission should adopt a three-stage approach to regulating basic service rates. The first stage would establish a table of benchmark rates, below which rates are reasonable. The second stage would provide for cases where cable systems exceed the benchmark rate because they face unusual or extreme service requirements. The third stage would, in extraordinary cases, allow for a full cost-of-service regulatory proceeding.

The purpose of the first two stages is to provide screening devices so as to reduce the administrative burdens on subscribers, cable operators, franchising authorities, and the Commission, as required by the law. The basic service benchmark rate should be based on the rates of systems that are subject to effective competition, relative to the rates of regulated systems, making due allowance for relevant differences in various system characteristics, such as system size, and programming levels. Because the statute places considerable emphasis on having basic rates reflect competitive conditions, the use of rates from competitive systems as an important factor should be attempted.

The purpose of the second stage is to take into account factors identified in the Cable Act of 1992 that may not easily be quantified when establishing the benchmark rate tables, or extreme factors that may apply only to certain cable systems. The adjustments allowed for in this stage would not require complete cost data, but would be based on factors that are readily identifiable, easily observable, and verifiable, and that are likely to increase a cable system's costs beyond those faced by the benchmark group. For example, certain requirements imposed by the franchising authority may obligate a system to incur extraordinary costs of service. A system may face significant costs in obtaining and providing signals on the basic service tier, in supporting public, educational, and governmental channels, or in providing services required under the

franchise. This stage of the regulatory approach would incorporate the cost of franchise requirements into the rate analysis without necessitating a full cost-of-service analysis.[12]

The third stage would come into effect only if the cable system requires a rate that cannot be justified using the results of the second stage criteria. In this instance, the cable system could request a complete rate hearing, where all cost data would be analyzed. It is through this procedure that the allocation of joint and common costs, the revenues received by the cable operator,[13] the allocation of franchise fees and taxes, and the reasonable profit criteria of the statute would come into play.

Details of the basic rate benchmark approach

The basis for the benchmark method is that basic rates in communities with effective competition would serve to establish presumptively lawful basic rates in communities without effective competition.

There are two problems that must be solved in order to compute reasonable benchmark rates. The first is that different cable systems within the benchmark group offer different services and have different costs, making it in-

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12 Communications Act, § 623 (b) (4), 47 U.S.C. § 543 (b) (4).

13 Cable operator revenues from sales of local advertising spots on satellite network channels, would to a significant extent automatically be taken into account in the benchmark rates if they were calculated in the manner described below. Competitive systems endeavoring to sell local advertising will have an incentive to charge lower subscriber rates than they otherwise would in order to increase the potential audience for sale to advertisers. If non-competitive systems fail to do the same, the benchmarks will be lower than otherwise.

appropriate simply to average their rates. For example, prior studies have shown that rates per channel vary among cable systems depending on how many channels are offered, and other factors.[14] Hence rates among the benchmark systems are likely to differ based on these factors. (It is of course for this reason that it would be impossible to have a sound regulatory scheme based on a single national benchmark rate for basic service.) The benchmark systems also are likely to differ in the extent to which they currently bundle equipment used to receive basic service and installation fees in the basic service rate. Similarly, the benchmark cable systems as a group will likely offer services and have costs that differ from the services offered and costs of the particular cable system to which the benchmark is being applied. In other words, there is a need to "keep other things equal" when comparing rates. It is possible to employ statistical techniques that "keep other things equal" and thus to determine the impact on basic rates of being an effectively competitive system rather than a regulated system.

The second problem is that, even after correcting for differences in the number of programming services offered, and for various other factors, there will remain a range of basic rates. There is no particular reason why only the average basic rate of the benchmark systems should be regarded as reasonable. Hence, it is necessary to define a range of reasonable basic rates. If a local cable system's basic rate fell within this range, it would be regarded as lawful.

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14 See *Competition, Rate Deregulation and the Commission's Policies Relating to the Provision of Cable Television Service*, 5 FCC Rcd 4962, Appendix F, and GAO, *Telecommunications: 1991 Survey of Cable Television Rates and Services*, Report to the Chairman, Subcommittee on Telecommunications and Finance, Committee on Energy and Commerce, House of Representatives (July 18, 1991).

For the purpose of establishing benchmark rates for basic service, B1 (for Benchmark 1) is defined as the price per subscriber per month for basic service (excluding franchise fees and state and local taxes) divided by the number of channels on the basic service tier. It is useful to express B1 on a per channel basis, both because the number of channels is likely to be an extremely important factor explaining variations in rates, and because to do so makes the regulatory scheme more conducive to the continued expansion of program services on the basic tier.

B1 Basic service. Benchmark rate based on competitive systems.	• Monthly rate for basic service *equals*: average basic service revenue per subscriber *divided by*: number of channels of basic service *equals*: **average basic service revenue per subscriber per basic channel: B1**

Regulation of the rates for basic service would be based on the benchmark rates of cable systems that are subject to effective competition. There are three kinds of cable systems that, under the statute, meet the definition of effective competition: those that face sufficient competition from a multi-channel competitor, those with relatively low (less than 30 percent) penetration, and those competing in franchise areas with systems operated by a local cable franchise authority. As a practical matter, the first type is limited at present to "overbuild" communities, where two or more cable systems compete for the

same subscribers.[15] Any of these groups of systems could be used to calibrate the benchmark.

One objection to the use of overbuild systems as a benchmark group to establish regulated rates is that some, perhaps most, overbuild systems may be in a disequilibrium "price war". In some cases, the entrant system is attempting to induce the incumbent to pay money in return for a cessation of competition, rather than to engage in long-term competition. Prevailing rates in such markets are probably below long-term competitive prices. Another objection is based on the fact that there are likely to be so few cable systems subject to effective competition of this sort. It may be difficult to use statistical methods to explain reliably the sources of variation of rates within a small sample. The first objection can be met by defining a "zone of reasonable rates" based on the competitive benchmark, a concept discussed further below. The second objection merely requires reliance on the characteristics of regulated systems in establishing a *framework* for benchmark rates, while using the competitive systems to establish the *level* of benchmark rates.

Specifically, econometric analysis can be used to identify those demand- and cost-related factors that are important in explaining the variations in rates (for basic service) among regulated systems; the very same analysis can then be used to identify the effect of competition on rates while holding constant the other cost and demand factors. The factors might include the number of chan-

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15 Before long there may be many communities where MMDS or DBS service will provide additional examples of systems meeting the definition of effective competition.

nels on the basic service tier,[16] the number or percent of basic service channels that are satellite-based networks, the number of subscribers, the total number of channels available, system capacity, and age of headend. Because some systems currently bundle equipment charges in their basic service fee, B1 will reflect some equipment charges; accordingly, variables to account for this may also be factors. Demographic factors such as household income, household size, and some measure of county or city size may also have explanatory power.

As noted above, there are two reasons for establishing by statistical analysis the factors that explain variations in rates among regulated cable systems. First, it is necessary to perform this analysis in order to identify the effect of competition on cable rates while keeping other things equal. Second, when establishing rate benchmarks, it is crucial to take account of the important factors that explain rate variations in order to avoid unnecessary "false positives." An example of a false positive in this context is a cable system that, because of the high-quality characteristics of its service, appears to be charging an excessively high rate but in fact is not. Identifying and holding constant important factors that explain how rates vary can avoid costly and unnecessary administrative proceedings for the false positives.

Using cable industry survey data to establish the benchmark rate for B1 requires the following steps. First, calculate the current value of B1 for all systems in a database derived from an adequately large stratified random sample of

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16 Even though B1 is defined on a per channel basis the number of channels is likely to affect B1. This is because the rate charged for the basic service tier is likely to increase with the number of channels on the tier but at a decreasing rate. This structure is a result of the large fixed cost, low marginal cost per channel, nature of a cable system.

cable systems. Second, for those systems in the sample subject to regulation (the "regulated sample"), use econometric procedures to determine the set of factors that best explains the variation in B1 across systems. Third, augment the regulated sample with the sample of effectively competitive systems (overbuilds and/or less than 30-percent penetration) and re-estimate the regression equation using the set of factors identified in the second step plus a dummy variable identifying the effectively competitive systems. The coefficient of the dummy variable is the "competitive adjustment factor". Fourth, partition the regulated sample into a number of cells (or into a matrix) based on selected readily observable key characteristics ("factors") in order to group similarly situated systems.[17] Fifth, for each cell, calculate the median value and the

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17 Suppose that the Commission were to determine that the number of channels on the basic service tier is an important factor in explaining B1 and wanted to take account of this factor in the benchmark rate tables. It is possible to segment the number of basic service channels into various sized cells, or to provide a table that reads in one channel increments. The benefit to using segments is that the Commission need not list a rate for every possible number of channels. The disadvantage is that as the size of the segments increases it is quite likely that the highest number of channels in one segment times the benchmark rate for that segment will be larger than the lowest number of channels in the next segment times the benchmark rate for that segment. This will induce a regulatory distortion when systems decide on the number of channels to offer on the basic service tier. Further, larger segments may imply using a linear approximation over a larger range of a non-linear relationship, increasing the number of type I and type II errors, and perhaps producing regulations that affect a different number of systems and subscribers than intended.

values defining the zone of reasonableness.[18] Sixth, adjust the values calculated in step five to reflect the competitive adjustment computed in step three.

An important step in the analysis is to identify those particular factors that should be used to establish benchmark rates. The criteria for choosing factors should include: (a) the importance of the factor in explaining rate variation, and (b) the soundness of the factor as a policy basis for rate regulation. An illustration of the operation of the first criterion might be one form or another of the variable "number of channels." As noted, this is likely to be a powerful explanatory factor accounting for per-channel rate variations among cable systems, and a benchmark approach that did not take number of channels into account

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18 With only a sample of systems, rather than the entire population, there probably will not be enough observations in most of the cells of the matrix to calculate the median or any other percentile. This problem can be alleviated by using information from all of the systems that meet certain criteria. This is accomplished by normalizing all systems so that they have the same characteristics as any particular cell of the table, and imputing the remaining variation to the distribution in each cell.

For example, suppose that the Commission decided to segment systems based on whether they had fewer or more than 1,000 subscribers and on the number of channels on the basic service tier. Then a regression of each system's B1 as a function of the number of basic service tier channels and whether or not the system has more than 1,000 subscribers would produce an estimated coefficient on the number of basic service tier channels that could be used to adjust each system's price per channel to what it would be given a particular number of channels. The systems need not be normalized on the basis of the number of subscribers, preserving the natural dispersions. If segments are larger than the individual numbers of channels, the mid-point value of a segment could be used to compute the normalized value for number of channels. After all of the appropriate subscriber-sized systems are normalized to a particular cell, the median and any other percentile values of that cell could be calculated.

would introduce many type I and type II errors into the regulatory process. An illustration of the second criterion might result if the analysis showed that, in general, cable rates were different in high income areas than in low income areas. It is doubtful that, as a policy matter, the Commission would wish to use income levels to establish benchmark rates. A second possibility illustrating the "policy" criterion is the factor "age of headend." The analysis might show that older systems charge higher prices, other things equal. But to base benchmark rates on this distinction is to introduce perverse incentives into the regulatory scheme. The Commission presumably would not wish to penalize cable systems that upgrade their headends.

Another key step in the process of establishing a competitive benchmark rate for basic service is to choose a particular rate from among those in the range within each cell, which have already been adjusted to reflect the effect of competition, in order to identify the upper end of the zone of reasonable rates.[19] One possibility is the average or, probably better, the median rate. But to that rate there are two serious objections. First, the median is affected by the likelihood, mentioned above, that rates in some overbuild communities reflect temporary price wars rather than stable equilibrium competitive prices. Second, to focus on the median competitive price is to lose sight of the fact that one-half of the competitive systems have rates above the median. It would be unreasonable to base benchmark rates solely on the lower half of the range of rates found among competitive systems.

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19 The competition-adjusted distribution of industry rates for systems with given characteristics is, by assumption, the same as the hypothetical distribution of rates for effectively competitive systems with the same characteristics.

Dealing with the preceding objections to the use of the median competitive rate suggests the establishment of a "zone of reasonable rates" for basic service, based on the existing distribution of rates in the industry for basic service, adjusted downward to reflect the results of competition in the benchmark communities.

Summary of B1 regulation

The procedure for establishing the competitive benchmark for basic service would therefore work as follows. First, the Commission would gather data using a stratified random sample of a large number of cable systems, both regulated and unregulated. These data would include rates for all regulated subscriber services items, along with as many objective factors likely to affect costs and demand as possible. Cost and other financial data would not be collected. As a practical matter, because there is no uniformity today in relevant accounting systems and definitions, it would not be possible to collect comparable cost data for competitive systems. Moreover, the benchmark approach is intended to avoid costly, time-consuming and contentious investigations of the costs of regulated systems by local authorities, relying instead on relatively objective and publicly available factors that underlie cost differences among systems.

Second, the Commission would conduct a statistical analysis of these data, with two objectives in mind: to identify the effects of competition and to identify the other objective factors that are important in explaining variations in rates across systems. The factors, or more likely a subset of the factors, would be used to form a table or grid, into one cell of which each regulated cable system in the country would fall. The upper end of the range of rates for basic service in each cell, adjusted downward to reflect the effects of competition,

would form a benchmark rate for basic service. This rate, most likely expressed in terms of cents of average revenue per subscriber per basic service channel per month, would serve as the upper limit on the basic rates regulated by local authorities. Basic rates below this upper limit would be reasonable. Cable systems that exceeded this rate would be required to meet the burden of showing to the local regulatory authority that special circumstances recognized under the Act justified their higher rate. And, in the rare and exceptional case, resort might be necessary to a full-blown inquiry into costs, cost allocations, and rates of return.

Finally, it should be noted that B1 contains no allowance for retransmission fees, for franchise fees and taxes, or for increased public, educational, and governmental access costs; these points are treated in greater detail below.

REGULATING CABLE PROGRAMMING SERVICES

The Cable Act of 1992 looks to a substantially different standard for regulation of cable programming services rates. In particular, when discussing the regulation of cable programming services, the Act does not require that subscribers be protected from rates that exceed the rate that would be charged if the system were subject to effective competition.[20] Rather the Act seeks to protect consumers from "unreasonable" rates, and it directs the Commission to consider

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20 "[T]he Commission shall, by regulation, establish the following: '(A) criteria prescribed in accordance with paragraph (2) for identifying, in individual cases, rates for cable programming services that are unreasonable;" Communications Act, § 623 (c) (1) (A).

rates charged by other regulated systems.[21] The legislative history explains the intent of this subsection through reference to the extreme or "renegade" cable system—a system that charges exceptionally high rates for a particular level of program service without justification. This standard can be understood best in terms of the range or distribution of rates among all regulated cable systems (or perhaps all cable systems).

The approach to cable programming service rate regulation proposed below constrains those systems with the highest unexplained *overall* system average subscriber revenue from *all* regulated services and equipment. The economic basis for this approach is the understanding that Congress found that cable systems have, or exercise, undue market power when they lack "effective competition". Market power, of course, is a matter of degree.[22] Cable systems today, like virtually every firm in the economy, may be assumed to have some degree of market power, varying from one system to another depending on local conditions, but only rarely reaching troubling proportions. Moreover, cable systems, because they must deal with the reality of local political forces exercised through franchise authorities, have non-economic constraints on their ability to exercise whatever market power they have. In some cases, these polit-

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21 "[T]he Commission shall consider, among other factors—'(A) the rates for similarly situated cable systems offering comparable cable programming services, taking into account similarities in facilities, regulatory and governmental costs, the number of subscribers, and other relevant factors;' " Communications Act, § 623 (c) (2) (A), 47 U.S.C. § 543 (c) (2) (A).

22 *Schurz Communications, Inc. et al., v. Federal Communications Commission and the United States of America*, Nos. 91-2350, *et al.*, (7th Cir., Nov. 5, 1992) slip opinion at 15.

ical constraints may be important; in other cases, the constraints may be unimportant. Further, and consistent with the above, some cable operators may simply have chosen to exercise self-restraint with regard to whatever market power they may have. Others may maximize available profits without self-restraint. In any case, the variations in rates that are not explained by objective physical system characteristics (taken into account by the Commission in establishing the benchmark tables) are assumed to be attributable in part to local differences in the extent and exercise of market power. All of this explains Congress' desire to regulate only "unreasonable" rates for cable programming services, and provides a basis to set a benchmark that reflects performance relative to the industry as a whole, such as the 98th or 95th percentile of subscriber average revenue.[23] Of course, any given rate might be above the benchmark on account of some factor entirely unrelated to the exercise of market power, such as extraordinary local cost conditions, and that is why it would be necessary to permit systems to make a showing that their rates are not unreasonable despite exceeding the benchmark.

The basket approach

In this section we describe a benchmark designed to determine which systems are above or below a "renegade" level of rates for cable programming services. For the sake of clarity, B2 (for Benchmark 2) is defined as a basket of services and equipment consisting of the basic service tier plus all regulated tiers of service above the basic service tier plus regulated equipment, additional outlets,

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23 The Notice at ¶46 mentions the "top 2-5%."

and installation.[24] Therefore, B2 is the weighted average revenue per subscriber from all regulated tiers of service (excluding franchise fees and state and local taxes), including the basic service tier, plus the weighted average revenue from each subscriber for all the regulated items of equipment, plus an amortized portion of installation fees,[25] where the weights are either the number of subscribers to a tier of service or the number of units of an equipment item relative to the number of basic subscribers, divided by the subscriber-weighted number of channels. B2 would be expressed on a per subscriber-channel per month basis. As noted above, revenues from regulated items of equipment are included whether or not the rates of these items are subject to separate regulatory constraints either individually or as part of an equipment rate basket, and whether or not there are restrictions on bundling of equipment with service.

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24 One justification for including basic service and the limited equipment used to receive basic service in the B2 basket is that in identifying rates for cable programming services that are unreasonable, the Act specifies that the Commission should consider, among other factors, " the rates, as a whole, for all the cable programming, cable equipment, and cable services provided by the system, other than programming provided on a per channel or per program basis;" Communications Act, § 623 (c) (2) (D), 47 U.S.C. § 543 (c) (2) (D).

25 One possibility is to amortize installation fees over three years. Paul Kagan Associates, Inc. estimates that the ratio of disconnects per month to total subscribers at the start of the month is 2.7 percent (*Marketing New Media*, August 19, 1991, p.1). This implies that the average subscriber lasts approximately 3 years. A TCI executive estimated that the industry's churn average is 27 percent-30 percent per year (*Broadcasting*, Oct. 7, 1991, at 50), implying an average subscriber lasts slightly over three years.